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Supreme Court of the United States

OCTOBER TERM, A. D. 1940

No. 872

A. B. GOCHENOUR, et al.,

Petitioners,

vs.

GEORGE AND FRANCES BALL FOUNDATION, GEORGE A. BALL and F. B. BERNARD,

Respondents.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

PETITIONERS' REPLY BRIEF

MEYER ABRAMS,
134 North LaSalle Street,
Chicago, Illinois,

JOSEPH L. STERN,
1909 N. B. C. Building,
Cleveland, Ohio,

HARRY J. MYERSON,
10 South LaSalle Street,
Chicago, Illinois,
Attorneys for Petitioners.

State Law Printing Company, 173 W. Madison St., Chicago—FRAnklin 5501

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The conspiracy to defraud the creditors was adjudicated by the Sixth Circuit since the filing of the petition.

In their "summary" of the argument (p. 2) counsel still *deny* the facts pertaining to the conspiracy. Of course, their denial cannot be considered in view of their motion to dismiss on jurisdictional grounds, whereby they have admitted the sufficiency and truth of each allegation. (*Bickford* v. *Fed. Res. Bank,* 5 Fed. Supp. 875.)

The petition showed (p. 3) that the bankruptcy court had adjudicated the conspiracy to defraud the creditors in the purchase of assets at the price of $889.00, and the attempt to recover in the reorganization proceed-

ings $15,135,614.99. This was the same sale at which assets involved in the instant case were purchased for $318,000.00 and later yielded about $6,000,000.00. Since the filing of the petition the United States Circuit Court of Appeals for the Sixth Circuit, in its opinion rendered on April 16, 1941, *adopted the findings set forth in the petition,* at page 3, and adjudicated that there was a *fraudulent conspiracy* in the purchase by Midamerica (see *In Re Van Sweringen,* Case Nos. 8646, 8654 and 8655, decided by the Sixth Circuit and not yet officially reported).* Among other things the opinion stated:

> "From the manner and under the circumstances in which, in association with outside enterprises,** the Van Sweringens, as directors of insolvent corporations, purchased these claims against their *cestui que trustent,* the debtors herein, at substantially less than real values. Equity and good conscience demand that the claims of the corporate creature, Midamerica, be limited to the amounts actually paid by it for the notes and bonds of the insolvent corporations."

The Court also said:

> "It seems soundly settled that one who knowingly joins a fiduciary in purchasing for profit the property of the trust estate in unlawful circumstances becomes jointly and severally liable with him for resultant profits."

It further said:

> "It is apparent here that the cupidity of persons in a fiduciary position has caused them to serve themselves in preference to those whom it was their duty to serve. Such dereliction is forbidden by just principles of law."

The only comment we can make is that *the same principles of law which were employed to deny $15,000,-*

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* See C. C. H. Bankruptcy Service Report 80 of April 23, 1941, Par. 53,126.

** The respondents here.

000.00 in claims to the respondents * should have equally been applied to cause them to disgorge the $6,000,000.00 in profits involved in this suit. If the action of the petitioners will be defeated on the technicality urged by the respondents the entire cause of action will be lost to the creditors, as the Statute of Limitations has expired.

I.

The complaint does not show on its face that the plaintiffs are not the real parties in interest, but on the contrary it shows that the plaintiffs are the real parties in interest, and the Debtor was either a nominal or proper party but not an indispensable party.

The contention (p. 8) that the complaint "shows on its face" that the cause of action is not in the plaintiffs is *contradicted by the allegations of the complaint.* They cannot by their motion to dismiss *supply a different cause.* (*Railway Express Agency* v. *Jones,* 106 F. (2) 341.) The complaint *did not allege* (as they contend) *that the corporation was defrauded.* On the contrary, it alleged (R. 3) that the officers and directors of the corporation *became "Trustees" for the "creditors"*; that as such Trustees "it became their duty to exert every effort" for the "creditors" and to notify *them* of the sale so that they might protect "their interest." It alleged that in *"violation of their duty and for the purpose of defrauding the creditors"* the defendants "conspired to acquire the collateral"; that by reason of the combination of the defendants with the directors of the corporation "to deprive the *creditors"* of the "benefits," and by "their failure to inform the creditors of their secret agreement" the defendants became liable to the *creditors.* It alleged that the of-

* This was done at the instance of the petitioners after the Debtor, the alleged trustee for the Creditors, admitted the validity of the claim.

ficers and directors of the corporation "never informed plaintiffs or any of the other general creditors of their acts and never afforded them an opportunity to bid at the sale." It prayed among other relief (R. 7) that it be decreed that the defendants "acquired the above securities and assets as Trustees" for the "creditors." The original complaint was framed on the theory that *all* existing creditors were entitled to such relief. The amendment *changed the cause of action to a distinct class* of creditors (R. 11).

It is therefore apparent *from the "face" of the complaint* that the cause as *alleged* was *available to creditors* and *not* to the corporation. The gist of the action was conspiracy to acquire the assets, without informing the creditors of the scheduled sale, and without giving *them* the opportunity to bid at the sale. It pivoted on the theory that *after insolvency the directors were trustees solely for the creditors* and *not* for the stockholders, and their trust duty was directly to the creditors. *No charge of fraud and no fraud was committed on the insolvent corporation which knew all of the facts and which was in no position to bid.** The corporation could not assert fraud when it knew of the scheduled sale, and it was in no position to bid. *The only persons against whom fraud was committed are the creditors who were in a position to bid and who were deprived of such opportunity.*

It is urged (pp. 8-9) that this is a derivative action because the collateral "was the property" of the corporation and not of the creditors and the conspiracy to procure the collateral "was a wrong against the Terminals" and therefore it is asserted that the right of action "would therefore lie with Terminals."

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* This is particularly true in view of the fact that this was a "one family corporation" (*Pepper* v. *Litton*, 308 U. S. 295) and the Van Sweringens merely used the corporations as an instrumentality as held in the former appeal by these appellants. (*Gochenour, et al.* v. *J. P. Morgan & Co.*, 111 F. (2) 378.)

The complaint did *not allege* that at the date of the conspiracy *the collateral was the property of the Terminals.* On the contrary, it alleged (p. 3) **that at the date of the conspiracy the corporation was insolvent and the corporation and its directors were then trustees for the creditors only; that as such trustees it was their duty to notify the creditors of the scheduled sale and to give them the opportunity to protect their interest and to bid at the sale;** that they violated their duty and by reason thereof *the creditors were defrauded,* and the collateral was acquired by the defendants. This was not a charge that the corporation was then the owner of the collateral. The charge was that by reason of the trust the creditors had an interest to the extent of bidding at the sale to acquire the collateral for their benefit. **The theory of the case** was not that the defendants were trustees for the corporation and that the corporation was defrauded, but **that the directors and the corporation were trustees for the creditors and that the creditors were defrauded.**

This was not a suit to set aside the sale of the collateral and to have the collateral returned to the corporation. It was a suit based on breach of trust to the creditors only. *The primary cause of action was failure to afford to the creditors the opportunity to bid at the sale.* It was a cause wherein the creditors only are interested and no one else. While the corporation might have been a proper party it was not an indispensable party. The right of creditors to maintain such an action was held to exist in *City of Fort Worth* v. *Nat. Park Bank,* 261 Fed. 817, 819, and in *Kitchen* v. *Conover,* 22 F. (2) 116.

Discussion of respondents' authorities:

The quotation (p. 10) from the *Ford Motor* case (80 F. (2) 723) is not in point. This case holds that *if a*

bankrupt has a cause of action the cause of action passes to the trustee in bankruptcy. The cause of action in the instant case was not vested in the corporation which was not defrauded, and the case is therefore inapplicable.

The *Isaacs* case (282 U. S. 734) which they cite (p. 12) involves property of the bankrupt, and the Court held that the trustee in bankruptcy was vested with the title no matter where the bankrupt's property was located. It is evident that it has no application on the issues involved here. The quotation from Glenn on Liquidation is not in point for the reason that it was predicated on the doctrine that directors of a corporation after insolvency are not "in the strict sense" in a fiduciary position which was adopted by many jurisdictions *outside of* Ohio. The Ohio courts have adopted the contrary view holding that directors of an insolvent corporation are in a strict sense trustees for creditors only. (*Young Love* v. *Lime Co.*, 49 O. S. p. 663.)

The *Greyling* case (74 F. (2) 734) simply decided that where a receiver was in possession of the assets of the corporation that upon the appointment of a trustee under Section 77B the trustee succeeds to the rights of the receiver. This has no remote application to the instant case.

II.

The jurisdiction of the res under 77B is no bar to this action.

We discussed the question (pp. 19-29) whether the jurisdiction of the *res* under 77B was a bar to the action for fraud by *cestui que trustent* against their trustees and for fraud against third parties and have shown that the Bankruptcy Court was only concerned with the administration of the *res* and with no other causes of action. Instead of answering our brief they quote from

many decisions, *none of which have the slightest application to the point involved.*

Even in cases where the Debtor has some interest, yet where the suit involves third persons the jurisdiction under 77B is not exclusive, for "Congress did not intend the Bankruptcy Court under Section 77B to take over all litigation between the Debtor and third persons." (*In Re Adolph Gobel, Inc.*, 80 F. (2) 849; *Re Prudence Bonds Corporation*, 75 F. (2) 262; *Thompson* v. *Terminal Shares, Inc.*, 104 F. (2) 1, 9.)

Authorities Not in Point:

The quotation (p. 13) from the *Lewis* case (291 F. 148) merely holds that a Trustee in bankruptcy is vested with the title of the bankrupt, a point not in issue. The *Trustee* case (3 F. 817) merely decides that a trustee in bankruptcy may bring action in the name of a bank for losses caused by the directors to the bank, a question not in issue here. The *Kelly* case (233 F. 635) decided that "when a corporation is injured through the negligence of its directors, the right to recover for such negligence is vested in the corporation." The injury here was not to the corporation but to the creditors who were not given the opportunity to bid at the sale and to protect their interest.

The *Klein* case (284 F. 979) merely decided that a receiver of a corporation has the exclusive right of action concerning property belonging to the corporation, a question not involved in this case.

The *Central Hanover Bank* case (99 F. (2) 642) is also not in point. All that that case decided was that a mortgagee need not make application to sequester the rents after intervention in bankruptcy.

The *Gross* case (289 U. S. 342), and the *Taylor* case (293 U. S. 470) cited by them (p. 4) simply state the

general proposition, which is not disputed, that a Bankruptcy Court has exclusive jurisdiction of the bankrupt's property. To the same effect is the *Trustee System* case (85 F. (2) 467). Counsel cite (p. 15) *Glenny* v. *Langdon,* 95 U. S. 20, and *Trimball* v. *Woodhead,* 102 U. S. 647, on the proposition that prior to the enactment of 77B the rule existed that after jurisdiction in bankruptcy and the appointment of a trustee no creditor has a right to institute legal proceedings to set aside a transfer or conveyance. It seems that counsel are of the impression that plaintiffs' complaint was to set aside the sale of the collateral. If the corporation was in a position to set aside the sale of the collateral on the ground of fraud against it, then, of course, the trustee in bankruptcy would succeed to such right. Under no theory of law could the corporation seek to set aside the sale of the collateral. The suit in the instant case is not a suit to set aside the sale of the collateral but a **suit for loss caused to the creditors for failure to inform them of the sale and to offer them the opportunity to bid at the sale and protect their interest founded on the doctrine that the corporation and its directors and officers were then trustees for the creditors.**

In *Beach* v. *Williamson,* 83 So. 860, the Supreme Court of Florida stated:

> "Officers of an insolvent corporation may have the right to buy the assets and properties of the corporation, but only after they have made a clean statement, to those most concerned, as to their beliefs concerning the value of the properties and possibilities for liquidation, to the end that the transaction may be kept free from possibilities of double dealing."

In the instant case the Van Sweringens controlled the parent and the Subsidiary. To whom were they to make this clean statement? Certainly not to themselves. It

was to the creditors that they owed this duty, and it is the creditors who have the right to maintain the action.

The decision in the *Los Angeles Lumber Products Co.* (308 U. S. 106) cited in their brief (p. 15) does not bear out their contention that the acquisition of jurisdiction over the *res* vests the Bankruptcy Court with jurisdiction over a cause of action by creditors against *third parties.* In the first paragraph which they quote the Court said:

> "Once the property is in the hands of the court, *private rights as respects that res* are subject to the superior dominion of the court and are to be adjudicated pursuant to the standards prescribed by Congress." (Italics ours.)

It is apparent that the Court confines the jurisdiction to *"rights as respects that res"* and no other rights.

Showing of Standing in a Distinct Class:

Counsel admit (p. 15) that petitioners alleged that they belonged to a "special class." They say that (p. 15) their "conclusive answer to this assertion is" that the Bankruptcy Court has not placed them in a different class and they cite the *Morgan* case. They seem not to be cognizant of the fact that they cannot contradict the complaint *by their motion.* They also lost sight that their motion to dismiss, based on jurisdictional grounds, constituted an admission as to the sufficiency of each allegation. (*Bickford* v. *Fed. Res. Bank,* 5 Fed. Supp. 875.) It was charged in the complaint (R. 11) that the "parent" which has a claim of $27,104,105.28, was not entitled to the relief due to the fact that the "parent" was a party to the fraud and knew of the facts and circumstances and is in a different class. It further alleged (p. 12) that J. P. Morgan & Co. has a claim of $27,777,718.27, but due to the fact that it actively par-

ticipated in the acquisition of the assets by Midamerica and knew all of the facts it stands in a different class and is not entitled to the relief.

If they wanted to deny the allegations of the complaint their proper denial could only have been made by an answer but not by a motion which admitted the truth of the allegations. A reference, however, to the reported case, *Gochenour* v. *J. P. Morgan & Co.* (111 F. (2) 378), which they say established that creditor in the same category as all other creditors, will show that the assertion is incorrect. *In that case the Court held that to the extent of $5,000,000, plus accrued interest from* October 1, 1931, to the date of the filing of the claim in 1936 the claim *was fraudulent* and as to that phase *the claim should be disallowed as to bona fide creditors.* The Court there said:

> "But, aside from inferences as to the value of the stock when purchased, and as to claimant's confidence in the Van Sweringen enterprises, the money was advanced at least partially upon the credit of C. T. B. which **we regard as but an instrumentality of Van Sweringen Corporation, by which it was owned** directly, and of **Vaness, by which it was owned indirectly.** Claimant knew this and we think it should share responsibility for a loan based upon the credit of a corporation which had **no independent voice** in its management, but which had **separate and independent creditors** who might be **adversely affected** thereby. C. T. B. bought the stock for five million dollars with option in Van Sweringen Corporation to repurchase it for the same amount on or before May 1, 1935. Assuming that it was worth six million dollars, it was beyond C. T. B.'s power to benefit thereby, and in addition, it was obligated to pay interest up to $1,350,000.00 on the money it had borrowed to make the purchase. If the option were exercised it was 'out' the interest. Van Sweringen Corporation might not exercise its option, but this contingency was beyond C. T. B.'s control.

> We think all evidence justifies, if it does not compel, the conclusion that claimant knew all this and that its own interest in the transaction was such as to **tinge it with fraud** toward C. T. B.'s creditors. (Bold type supplied.)
>
> Our holding and decree is that that portion of the claim based upon this five million dollars should be and is held as **secondary to the rights of the bona fide creditors** of C. T. B."

It is apparent that at least to the extent of the $5,000,000, plus accrued interest of approximately another million dollars, *that creditor stands in a different position.* The fact that a claim was allowed in the 77B proceedings *insofar as it relates to the assets of the Debtor,* does not make that creditor, who participated in the fraud and *who knew of the sale,* and who itself made the sale, *a participant in a cause of action by defrauded creditors.* The fact that the "parent" was allowed a claim in the 77B proceeding against its Subsidiary does not adjudicate the right of the parent which was a party to the fraudulent sale to participate in a cause of action *against third persons* by bona fide creditors who were defrauded.* Both the Debtor and Subsidiary Debtor were mere instrumentalities of the Van Sweringens, and they do not stand in the position of the bona fide creditors who were defrauded. At any rate, *such were the allegations of the complaint which they admitted to be true,* and they cannot seek to sustain their motion by denials.

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* This alone is sufficient to demonstrate the absurdity of the contention that the right of action belongs to the Debtor. Under this theory the result will be that creditors who participated in committing the fraud, would participate with the defrauded creditors in the proceeds realized out of the cause of action, which under no theory of law was available to the creditor who committed the fraud or who was a party to it.

III.

The District Court in the 77B proceeding was without jurisdiction of this cause of action, and the action was not an interference with the orderly and proper administration of the Debtor's estate.

This subject matter was fully discussed in our Brief (pp. 29-32). The discussion in respondents' brief of this point under Point III is not responsive and none of the cases cited by them are in point. The *Greyling* case (p. 18) was shown above to have no bearing on the question involved. The quotation from the *Los Angeles Lumber Products Co.* (p. 19) is repeated from the first part of the quotation appearing on page 15 of their Brief, and we have already shown that that paragraph confines the jurisdiction to the *res*. The decision in *Re 7000 South Shore Drive Building Corporation* (86 F. (2) 499), stands for the doctrine that "exclusive and paramount jurisdiction over the *res* of the estate passed to the court of bankruptcy," which is not at all in dispute.

On page 20 counsel say:

> "The chaotic condition of the administration of the bankruptcy estate cannot be over-estimated if creditors such as plaintiffs here are permitted to maintain actions after a debtor corporation has taken steps under Section 77B to reorganize."

A chaotic condition in the administration of justice would indeed follow if the respondents will prevail. Here was a cause of action which if true, as contended by the defendants, was available to the Debtor a year prior to its filing of its voluntary petition for corporate reorganization. No such action was commenced. *Five years (less twelve days) elapsed,* and no action was commenced by the Debtor. If plaintiffs did not commence the action it would have been outlawed by the Statute of Limitations. When the action was commenced the Debtor

refused to join because it considered the action *worthless.* It later applied to the Court for instructions to commence the action at an expense of $25,000.00. The Court instructed the Debtor not to commence the action and *dismissed its application,* and no action was ever commenced. The subject matter of this suit has never been, nor is it now, under the administration of the District Court in the 77B proceeding, yet it is urged here that the allowance of the prosecution of this suit by the creditors who were defrauded at their own expense would create a chaotic condition! They claim that a chaotic condition would result from the fact that the plaintiffs asked for the appointment of a receiver during the pendency of the cause to take charge of all the property belonging to the trust estate. *The Receiver was not sought to take possession of any of the property of which the Bankruptcy Court is possessed.* The receivership was sought (R. 18) of the property which the defendants, *third persons,* are possessed of and *which is not in the possession of the bankrupt nor in the possession of the Bankruptcy Court.* In any event, the prayer for relief to which one may not be entitled is no obstacle to the relief to which a creditor is entitled. If the Court will decide that no receiver should be appointed it will deny the relief, but this is no obstacle to the right of action.

In answer to the point made in our Brief (pp. 20-21) that the Debtor, having refused to prosecute the cause of action, the right accrued to the plaintiffs as creditors, and even if the cause of action belonged to the Debtor, the jurisdiction was relinquished counsel say (p. 20):

> "No question is presented here respecting the abandonment by the Trustee of any cause of action against these defendants which it might have."

The question is presented by the record. *It is they who presented the question.* They brought in by their motion

to dismiss the records consisting of the complaint filed at Cleveland, the report of the Master and the Exhibits attached thereto (R. 14-34). We did not want to resort to technicalities on the point that they had no right to bring in these documents under their motion to dismiss and therefore stipulated (R. 35) that these records may be considered. *Having brought in these records which disclose the abandonment by the Debtor of the cause of action as it appears from its record* (R. 27, 28), *they cannot now about-face and claim that no such question is presented.*

The decision in the *Moyer* case (p. 21) on the point that the refusal or failure of a Trustee to sue does not transfer the cause of action to the creditor has no bearing here as there was no discharge in bankruptcy. It has no bearing to a proceeding under 77B *where a Court may relinquish its jurisdiction to certain phases* in favor of another Court, as shown in our brief (pp. 26, 27). We find no answer to the argument nor are the authorities disputed.

IV.

The decisions are conflicting and irreconcilable.

The attempt to reconcile the conflicting decisions (pp. 22-24) is in vain. A reading of the cases will dispose of the unsuccessful attempt.

The recent decision of the Sixth Circuit in the Gochenour appeal and which was mentioned in the petition (p. 9) is quoted at length by respondents. The opinion is not yet officially reported but appears in C. C. H. Bankruptcy Service at paragraph 53.052. We stated in the petition (p. 9) that this opinion squarely holds against our contention, but we intend to apply for a review of that decision. This does not detract from the fact that

there is a conflict between the various Circuits on the main question whether or not the right of action belongs to the petitioners as creditors or to the debtor. The opinion contains also, among other things, the following:

> "On September 30, 1935, the Midamerica Corporation purchased at private sale from Morgan & Company, for $318,000.00, the collateral on the subsidiary-debtor's note. Subsequently, Midamerica sold these securities for $6,805,800.00, and went into liquidation, distributing the proceeds of the sale to its stockholders. The subsidiary-debtor was insolvent at the time these transactions occurred."

In commenting on the failure of the debtor to take action and on the fact that the Court did not bring this asset under its administration, the opinion says:

> "However, it is not the purpose of the Act to furnish immunity to wrong-doing by corporate officers. On the contrary, it is the plain duty of the court to direct the investigation of all substantial allegations of mismanagement or fraud. Under the Act, if a corporate debtor is continued in possession of its assets the judge may at any time, appoint a disinterested person as an examiner to perform the duties imposed upon a trustee. (Ch. 541, Sec. 168, as added June 22, 1938, ch. 575, Sec. 1, 52 Stat. 890, Title 11 U. S. C. A., Sec. 568.)
>
> In the present case the court below, as its orders clearly indicate, has not considered the practicability of the appointment of an examiner. On the face of the information in the record there are reasonable grounds to believe that the officers of the subsidiary-debtor through their control have improperly acquired its assets and by reason thereof, have become indebted to the corporation to the extent of the profit they have realized by reason of their misconduct."

It afforded the following remedy:

> "While the petitions filed by appellants were not filed on behalf of the subsidiary-debtor, neverthe-

> less, they will be treated as presenting sufficient facts to require the court to appoint an examiner and if facts are produced upon a hearing which convince the court that suit should be prosecuted for the benefit of the subsidiary-debtor against the officers, stockholders and directors of the Midamerica Corporation, an order will be entered authorizing the subsidiary-debtor to prosecute the suit or if the court deems proper, it may give appellants, as creditors of the subsidiary-debtor, the right to institute suit in its name after indemnifying it against cost. Cause remanded for proceedings consistent with this opinion."

This "cure" if administered, may not save the "patient," as the Statute of Limitations has now elapsed (see Petition, p. 31) and no matter what an examiner may discover, it may not bring relief to the creditors or to the bankruptcy estate.*

For the foregoing reasons, we urge the allowance of the Writ.

Respectfully submitted,

MEYER ABRAMS,
JOSEPH L. STERN,
HARRY J. MYERSON,
Attorneys for Petitioners.

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* After a lapse of about six years, the Bankruptcy Court is to appoint an examiner, who is to hear evidence and submit a report to the Court, which will then determine what further steps are to be taken. During the six-year interval, Midamerica, a resident within the Federal District where the bankruptcy proceeding was pending, succeeded in disbursing the funds to the respondents, Indiana residents. What further steps will be taken by the respondents between the time that will elapse for such examination and determination by the Court can, of course, not be foretold at this time. While the appointment of an examiner would be a great aid if the cause of action would remain pending, it may be of no use for the reason that the officers and directors will be able to interpose the defense of the Statute of Limitations.